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UNCLAS SECTION 01 OF 02 BRASILIA 002649

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AID/W FOR LAC/SA

E.O. 12958: N/A
TAGS: ECON EFIN ETRD
SUBJECT: THE SURGING REAL HAS EXPORTERS SINGING THE BLUES

REF: Brasilia 2477

¶1. Summary. The Brazilian export sector is pressuring the Central Bank to curb the slide of the dollar (US$) against the Real (R$). As of September 29, the dollar was trading for Real 2.21, its lowest price since May 8, 2001. Exporters are concerned that if the devaluation of the US$ against the Real continues, the healthy growth in exports which the country saw in 2004 will come to an end. The Real has appreciated 15.4% so far this year and 24.8% in the last 12 months. End Summary.

Impact of the Exchange Rate on Exports
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¶2. The Brazilian government's Institute of Applied Economic Research (IPEA) has just released a study regarding the current exchange rate. The study, based on information gathered from 36 industries, shows that most exporters could withstand an appreciation of the Real of up to 30 percent from its point of equilibrium (about R$2.90 to the US$) as their losses would be less than if they abandoned the overseas market altogether. Subtracting 30 percent from R$2.90 would yield an inflection point of about R$2.00 - i.e., the level at which, if breached, Brazilian exports would begin to drop significantly.

¶3. While exporters and the private sector are blaming the declining exchange rate as one of the key reasons Brazil could lose ground overseas, government policy makers appear less worried. Minister of Development, Industry and Commerce Luis Fernando Furlan, (i.e., the principal advocate for the business community with the government) has noted "Brazil has room to improve its infra-structure and lower the cost of exports." In other words, efforts to improve infrastructure, reduce costs, and increase efficiency might compensate for the unfavorable exchange rate. To a certain extent, some of this is already happening. Well-known macro consultant Carlos Langoni argues that as a result of: 1) large imports of capital goods, 2) better use of information technology, and 3) skilled intensive labor, productivity growth is increasing. Data from the IBGE (Brazil's main statistical agency) points to 6 percent productivity growth in the industrial sector in 2004 and 2.7 percent this year through July.

The Central Bank's Line
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¶4. During his recent visit to Washington for the Bank Fund meetings, Central Bank President, Mr. Henrique Meirelles, told investors that the Central Bank is not going to intervene in the market, noting that under the floating rate system (which Brazil has had in place since 1999) exchange rates must float. Inflation, he declared, was still the number one enemy of the Brazilian economy. Meirelles said that while Central Bank will continue to buy dollars the objective of these purchases will be to increase foreign reserves and not to intervene in the exchange rate market. As Meirelles will likely remain as Central Bank President, having desisted from his early stated intention of running for Governor of Goias State, this hands-off approach could represent Central Bank policy for the foreseeable future.

Market Fundamentals
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¶5. During the past few weeks three factors have driven the continuing devaluation of the dollar against the real. First, has been the emerging perception that the government will maintain its embrace of sound economic fiscal policy notwithstanding the threat of presidential impeachment or departure of Finance Minister Palocci from the cabinet. Second, the market is expecting Brazilian interest rates to decline slowly but surely, with GOP growth prospect improving accordingly. Last but not least, are the signs that the Fed will continue to tighten monetary policy in the United States. These developments have raised the country's profile among emerging markets in the last two weeks and

foreign investors have started looking for Brazilian assets. Parking money here is tempting as real interest rates are 13%, the highest in the world, and EMBI country risk has declined to 353 basis points.

¶6. According to Luiz Sergio Guimaraes, journalist at the daily financial newspaper "Valor Economico", another factor behind the devaluation of the dollar against the real is the speculative operations that are being launched by foreign arbitrage investors. While the market consensus predicts an exchange rate of 2.35 by the end of the year, those foreign investors who believe the dollar will continue to fall are buying Reais thus further contributing to the dollar's weakness.

¶7. For his part, Afonso Bevilaqua, Director of Economic Policy at the Brazilian Central Bank, theorizes that the current appreciation of the Real is due to an increase in prices of the goods and services the country exports. In a recent press article, he noted that it was natural that the Real would strengthen as Brazil is richer now than it was before. Bevilaqua disagreed with market analysts who think that the high interest rates are the main reason behind the strong Real. The balance of payments (BOP) numbers, he stated, do not show any influx of foreign capital into Brazil as a result of the high interest rates. Bevilaqua pointed out that the government's September 2005 BOP report shows the bulk of the capital inflow was long term. From January to August 2005, there was US$ 15.5 billion entering as long-term capital and US$ 5.3 billion as short-term capital.

Comment
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¶8. The current situation, with the Brazilian Real steadily gaining against the dollar at the same time as exports reach records numbers, is somewhat worrisome and at best awkward for the Brazilian economy. Notwithstanding the non-interventionist comments of Central Bank Chief Meirelles, Brazilian Government authorities surely would like to identify for certain where the equilibrium point is, that is, what exchange rate ratio is business-government-market acceptable while still allowing for continued export growth. And while the IPEA study contemplates no large drop off in exports until the dollar hits the 2.0 reais level, it is clear that some exporters will be hurt long before it reaches that point. The automakers, for instance, have repeatedly told us that the breakeven point for their exports is around the 2.6 level. To date, however, the exporters who have been hurt the most are small and medium sized companies (SMEs). It has traditionally been hard for the SMEs to develop their clientele base and enter the foreign markets. Now they see their prices going through the roof as they lose ground to their competitors. All that said, Brazilian SME exporters won't give up easily. It is in their interest to keep and maintain their markets overseas, and that is where the GOB is putting its cards. The government's message to the exporters is simple. Cut costs, increase efficiency, and find new and cheaper ways to do business. The most immediate effect has been that in an effort to improve their cost structure, SMEs have begun to lay off employees. However, should the exchange rate remain at or near the current level for an extended period of time, they will also need to improve quality and cut margins if they are to survive.

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